



CRM and More Streamlined Disclosure – Effective Measures to Address the Worst Aspects of Investor Behavioural Psychology

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When Martin Wheatley, CEO, U.K. Financial Conduct Authority (FCA), wanted to demonstrate that people don't read information that is important to them, he couldn't have made the point more effectively. During a speech at the recent International Organization of Securities Commissions (IOSCO) meetings several weeks ago, he asked his audience if they had read the terms and conditions to download the latest iOS 8 iPhone software. Almost no one raised their hand. This reluctance to read dense, complex information – and the difficulty of understanding much of it – raises questions about whether full disclosure by itself enables investors to make informed and rational investment decisions.

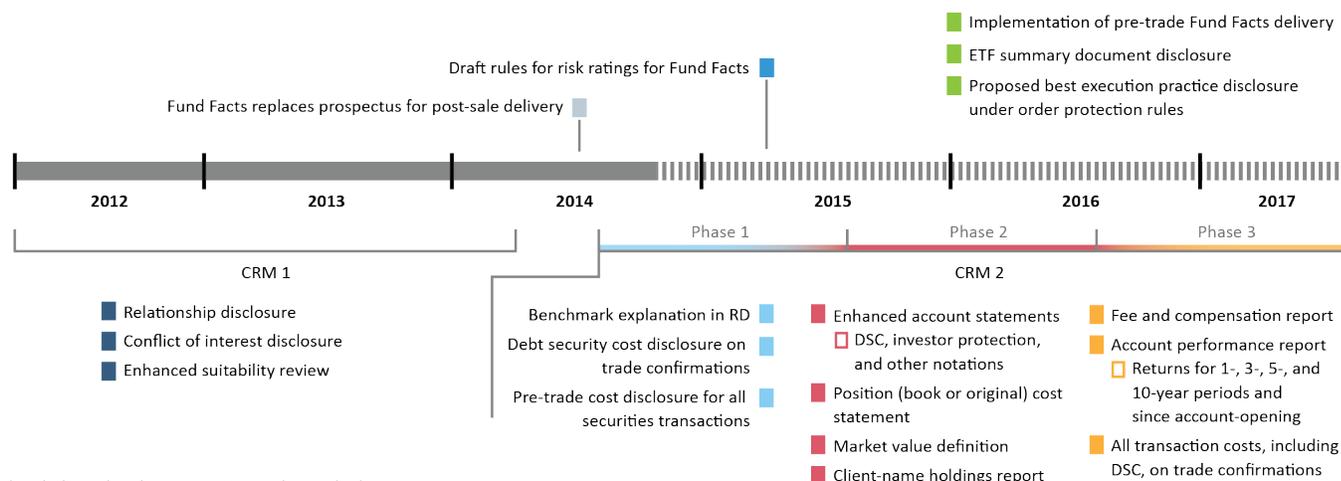
The detailed disclosure of investment information and investment costs has been the theme of recent reform efforts in the wealth management business. The CRM 1 and 2 rule framework mandates broadened and standardized disclosure of the investment process including: conflicts of interest; fees including dealer and advisor compensation; book or

original cost; additional statement enhancements; and portfolio performance. These CRM initiatives complement IIROC's enhanced suitability rules and improved mandatory disclosure of mutual fund investments (Point of Sale), notably summarized disclosure through the "Funds Facts" document, and requirements for the distribution of this abbreviated disclosure. The focus on full disclosure as the key bulwark of investor protection is consistent with the approach taken by regulators for the past 60 years.

"Full" disclosure of more than just material facts: Valuable only if it is fully used

There is an increasing body of evidence, based on the analysis of behavioural psychology by economists like Daniel Kahneman, author of "Thinking, Fast and Slow", that, even given full information and disclosure, and even if this information is actually read and understood, investors still make less-than-optimal investment decisions. Many investors don't have the capacity to understand the complexity of most

Client Relationship Model (CRM) and Other Investor Disclosure Initiatives*



* Includes only select securities regulatory disclosure requirements

Source: IIAC

financial decisions, much less take the time to understand them. As a result, investors fall back on intuition and instinct in making decisions, particularly when most financial decisions are complex and arcane. Investors take shortcuts in making decisions. In this regard, Jonah Lerner in a recent issue of the *New Yorker* commented that “shortcuts aren’t a faster way of doing the math; they’re a way of skipping the math altogether.” What makes matters worse is that investors often avoid reading available disclosure material. This is certainly the case for investors when it comes to intricate and detailed prospectuses, and other cumbersome, required regulatory documents.

So, what does this evidence mean for investors? The research indicates investors often overstate the short-term at the expense of the long-term; they fail to identify embedded fees even when disclosed; they react to the visible features of the investment product; they fail to take full account of the compounding effect of interest rates; and they often neglect to read the detail of disclosure material.

The question for regulators: Is disclosure enough and what should they do about it?

The foregoing analysis and conclusions from behavioural economists suggest full disclosure is no guarantee investors will make rational investment decisions. This raises a dilemma for regulators. Regulators have a responsibility to protect investors, so have they done enough by relying on disclosure, combined with proficiency standards for advisors, rules of market conduct and the safety of client assets? Moreover, detailed disclosure in offering documents and other materials may even be counter-productive and excessively expensive, simply confusing and obfuscating investors.

But where does regulatory responsibility begin and end?

One view is that once full disclosure is available and readily accessible, and advisors meet defined standards of proficiency and conduct, then “caveat emptor” should be the order of the day. The responsibility for interpreting financial information is left with the investor and his or her advisor, or to just the investor if he or she chooses to go it alone.

The alternative view, embraced by the U.K. regulator, FCA, is that regulators should go further and take responsibility to compensate for the distorting effects caused by the behavioural psychology of investors. Accordingly, the new FCA rulebook includes the requirement to designate advisors either independent (selling the full range of investment products) or restricted (selling a sub-set of investment products), the prohibition of embedded or hidden commissions and the prohibition of commissions paid by third parties to address conflicts of interest.

The advantages of CRM: Disclosure – and a deeper client/advisor relationship

So what steps should Canadian regulators take? The first point is that further remedial action should be viewed through the lens

of the newly implemented CRM rule framework, as well as the responsibility that investors should take for their actions. Much thought, and enormous investment of time and resources, has been expended in the rule-making and implementation of CRM 1 and 2. One can conclude from the CRM provisions that, while not intentionally focused on behavioural psychology of the investor, the framework provides an effective counter-measure.

In fact, the CRM rule framework is unique. It requires the disclosure of all fees and commissions, the management of conflicts of interest (such as payment of third-party commissions), and the effective unbundling of fees and charges, both pre-trade and annually. But, as well, the CRM encourages a deeper relationship between client and advisor by mandating more frequent suitability reviews. A strong interactive relationship is the key to building investor knowledge and understanding, helping investors avoid the pitfalls of neglecting or short-circuiting important financial information, and guiding them to optimal decisions.

Key observations

Some key observations important to keep in mind when assessing the appropriateness of existing regulations and determining the right balance of regulatory responsibility are as follows:

1. An integral part of the CRM is the enhanced suitability requirements that mandate more frequent suitability review, triggered by transactional decisions and significant life events. These reviews assess portfolio positions and investment decisions in relation to client investment objectives and risk tolerance. This assessment involves a close dialogue and interchange with the investor on financial decisions, complementing the availability of written material related to investment and portfolio performance. These measures mitigate the distorting impact of behavioural psychology on decision-making.
2. The mandated disclosure of all dealer and advisor fees and commissions under the CRM rules ensure investors are made aware of detailed fees and charges related to investment decisions. Advisors must refer to this information in advising clients before an investment decision.
3. Regulators and investor advocates treat all investors as a homogeneous group. The reality is quite different. Affluent investors on average are typically more knowledgeable and have sufficient portfolio size to fund advice through qualified IROC registered advisors. The less affluent investor (less than \$200K in investable assets) may have less understanding of financial products and markets. As well, these investors are less likely to need a deep relationship with their advisor until later in their lives. Regulators may consider increased proficiency standards and better practices for non-IROC registered advisors dealing in the mass market.
4. Investor education is important to immunize against the

risk of bad choices in financial decision-making. Despite the availability of educational tools from a multitude of sources, the investor take-up is minimal. You can take a horse to water, but you can't make it drink. Most investors are disinclined to take time to learn more about investing, until the time they need it and that is usually when they start working with an advisor. The close client-advisor relationship strengthened by enhanced suitability review under CRM provides the most effective forum for educating the client and contributing to good decisions.

5. The need to provide additional regulations to offset the negative consequences of behavioural psychology is mitigated by the fact that for advisors with IIROC registered firms, more than one-half of the retail revenue in the industry is fee-based. Fee-based accounts and discretionary managed accounts avoid the conflicts that can be associated with commission-based transactions.
6. The evidence that confirms investors fail to read disclosure materials due to complicated subject matter and the disinclination to invest needed time argues for stepped-up efforts to streamline and simplify disclosure documents. For example, prospectuses and continuous disclosure documents should provide a concise, two-page plain-language overview of issues material to the investment decision.

Conclusion

The Client Relationship Model provides an effective framework for improved disclosure, particularly targeted at “just what you need” disclosure, and encourages better advisor interaction with the client to improve the calibre of financial decision-making. The strengthened relationship between advisors and clients under the CRM rules promotes more effective decisions and provides an antidote to the worst aspects of the behavioural psychology of investors. The CRM is sufficient for IIROC registrants and their firms. What is needed is clear, abbreviated written disclosure to promote better understanding in other areas of high concern. This should be the top priority for regulators.

Yours sincerely,



Ian C. W. Russell, FCSI
President & CEO, IIAC
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